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"We cannot ask foreign investors to come and then not let them make money."
Deng Xiaoping
September 4, 1986[1]

I. Introduction

As the People's Republic of China (China or PRC) continues its policy of invigorating its economy by integrating itself further into the international economic system and by utilizing foreign capital and technology, foreign investors have confronted the difficult problem of the inconvertibility of China's currency, the renminbi (literally, the people's currency). When China first opened its doors to foreign investment in 1979, the government placed extremely tight controls on the conversion of renminbi into foreign exchange. Currently, under normal circumstances, renminbi cannot be converted into foreign exchange for the operational requirements of foreign investment enterprises[2] (such

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1. Deng states that "[i]nvestors [m]ust [p]rofit . . . ." Ta Kung Pao, Sept. 11, 1986, at 4 (Weekly Supp.).

2. There are three basic forms of "foreign investment enterprises" in China as the term is used in this article: equity joint ventures, cooperative (or contractual) joint ventures and wholly foreign-owned ventures. Equity joint ventures and cooperative joint ventures are collectively referred to as "joint ventures" in this article. Each of the three basic forms is regulated by its own special legislation, as well as certain common administrative, tax, and other regulations. Foreign companies may also set up representative offices and contract for construction projects, management services, processing and assembly operations, compensation trade arrangements, leasing of equipment, and licensing of technology, and they may jointly develop offshore and onshore oil and other min-

as the servicing of hard currency loans, import of equipment, parts or raw materials, and payment of expatriates' salaries and technology licensing fees) or for the purpose of repatriating the investment and profits of foreign investors.[3] Yet receipts from domestic sales by enterprises established in China are normally in renminbi; thus the enterprises' chief source of foreign exchange is income from export sales.

PRC foreign investment laws and regulations[4] and public statements by Chinese leaders[5] make it clear that China is seeking to encourage investment in manufacturing enterprises in both export-oriented industries and the advanced technology field. If successful, foreign investment enterprises in the first category have little difficulty earning sufficient foreign exchange

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eral resources in China. None of these forms of business is included within the term "foreign investment enterprises" as that term is used in this article. For an overview of foreign direct investment in China, see Cohen & Valentine, *Foreign Direct Investment in the PRC: Progress, Problems and Proposals*, 1 J. CHINESE LAW 161 (1987).

3. The State Council issued the Interim Regulations on Foreign Exchange Control of the People's Republic of China in late 1980 [hereinafter Exchange Control Regulations] to provide a legislative basis for maintaining strict centralized controls on foreign exchange transactions in the context of China's newly adopted open economic policies. Unless otherwise indicated, the Chinese text and English translation of all laws and regulations cited in this article may be found in one or more of the following publications: 3 CHINA'S FOREIGN ECONOMIC LEGISLATION (Foreign Language Press, Beijing 1987); 2 CHINA'S FOREIGN ECONOMIC LEGISLATION (Foreign Language Press, Beijing 1986); 1 CHINA'S FOREIGN ECONOMIC LEGISLATION (Foreign Language Press, Beijing 1982); China Laws for Foreign Business (CCH Austl. Ltd. 1987).

Article 3 of the Exchange Control Regulations states that China "pursues a policy of centralized control and unified management of foreign exchange by the State." Article 4 requires all Chinese and foreign institutions and individuals in China to sell all their foreign exchange receipts to the Bank of China and prohibits the circulation, use, or pledging of foreign currency within China and the sale and purchase of foreign exchange without authorization. There are, however, certain exemptions for foreign investment enterprises, foreign diplomatic missions, and their personnel, including qualified rights to maintain foreign exchange bank accounts and remit after-tax profits and earnings overseas. *See, e.g.*, Wang Zhongfang, *Legal Safeguards for Chinese-Foreign Economic Cooperation*, in LEGAL ASPECTS OF FOREIGN INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA 26, 30 (1988).

4. This is reflected best by those adopted since early 1986, such as the Provisions of the State Council Regulations Concerning Encouragement of Foreign Investment (promulgated October 11, 1986) [hereinafter 22 Articles] and the range of implementing regulations issued at local and national levels pursuant thereto. For a general discussion of the 22 Articles and an English translation of their text, see Cohen & Chang, *New Foreign Investment Provisions*, CHINA BUS. REV., Jan.-Feb. 1987, at 11.

5. *See, e.g.*, Statement by Vice Minister Zhang Haoruo, of the Ministry of Foreign Economic Relations and Trade, *quoted in* China Daily, Mar. 7, 1987, at 1, col. 1 ("We will be more strict in selecting projects for foreign investment. . . . Export-oriented and advanced technology enterprises will be encouraged, and special treatment will be provided upon examination and confirmation.").

to offset their foreign exchange expenditures; however, those investment enterprises in the second category are often not export-orientated and are, therefore, frequently prone to foreign exchange shortages.

According to Chinese government statistics, only one-third of the 4,000 foreign investment enterprises operating in China by the end of 1987 were able to balance their foreign exchange accounts.[6] Foreign exchange deficits are common during the early years of operation of an otherwise successful foreign investment enterprise. The deficits tend to occur before the enterprise has established export channels, developed a product competitive in the world market, and arranged to obtain or source most materials locally at competitive prices. In the hope of attracting a larger amount of foreign investment, especially in the advanced technology field, China has recognized increasingly that it must offer foreign investment enterprises other options in addition to export of their products in order to help them maintain a foreign exchange balance. Thus, it has recently promulgated a number of relevant regulations.

This article will briefly survey the various options now available to foreign investment enterprises to help balance their foreign exchange receipts and expenditures and will examine in somewhat greater detail the legislative basis and practical implementation of one of the more promising of those options—import substitution.[7]

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6. Statement by Zhu Rongji, Vice Minister of the State Economic Commission (now Mayor of Shanghai), *quoted in* Xu Yuanchao, *Consulting Body set up to aid Joint Ventures*, China Daily, Nov. 26, 1987 at 1, col. 1. Two years earlier, a senior official of the Ministry of Foreign Economic Relations and Trade, Chu Baotai, reported that foreign investment enterprises in 19 key provinces and cities imported $1.28 billion worth of parts and materials in 1985 but were only able to generate foreign exchange income of $472 million through exports in the same year. S. China Morning Post, July 16, 1988, at 3.

7. Although China's "open" economic policy is still relatively new, having been introduced in 1978, the concept of import substitution in its broadest sense is very familiar in China. The goal of localizing production to avoid dependence on imported products is common to many developing countries around the world and was a central pillar of the economic policies of Mao Zedong that were pursued under the slogan of "self-reliance" in the first decades after the Chinese Communist Party came to power in 1949.

In this article, the term "import substitution" is used in a much narrower sense to refer to the methods by which foreign investment enterprises in China may, under certain conditions, earn foreign exchange for goods produced and sold within China that would otherwise have been imported.

II. Methods Other Than Import Substitution for Balancing Foreign Exchange

As a result of the PRC's recent legislative effort, it is now possible, upon the satisfaction of certain conditions, to adopt one or more of a variety of foreign exchange generating methods for the purpose of balancing foreign exchange receipts and expenditures of a foreign investment enterprise.

A. Currency Swaps

One method that has become increasingly popular is the trading or "swapping" of renminbi for foreign exchange among foreign investment enterprises and some Chinese enterprises. Swapping, which takes place under the supervision of the State Administration for Exchange Control (SAEC), was first sanctioned in January 1986 by the provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures (Foreign Exchange Balancing Provisions).[8] Currency swapping under these provisions was, however, limited to the "adjustment" of foreign exchange surpluses and deficits between joint ventures established by the same foreign investor. Some foreign investors, in order to achieve a foreign exchange balance, have established joint ventures with two product lines—one for sale mainly within China and one for export. Nevertheless, only a few foreign investors have set up more than one joint venture in China. Moreover, China has not been receptive to the idea of allowing foreign investors to set up holding company-type joint ventures, whose functions could include the balancing of foreign exchange.[9]

In October 1986, the concept of adjusting foreign exchange surpluses and deficits through currency swapping was extended by the 22 Articles[10] to allow any foreign investment enterprise (*i.e.*, wholly foreign-owned enterprises as well as joint ventures) to carry out adjustments with any other such enterprise. Within

8. Provisions of the State Council on the Question of the Balancing of Foreign Exchange Receipts and Expenditures of Chinese-Foreign Joint Ventures (promulgated Jan. 16, 1986) (trans. in Chang, *Foreign Exchange Balancing Provisions for Joint Ventures*, E. Asian Exec. Rep., Feb. 1986, at 7) [hereinafter Foreign Exchange Balancing Provisions].

9. *See* Cohen & Valentine, *supra* note 2, at 190.

10. *Supra* note 4, art. 14.

a remarkably short period a currency swap market emerged. Foreign investment enterprises that needed foreign exchange began selling renminbi for hard currency at a premium over the official exchange rate to foreign investment enterprises that enjoyed foreign exchange surpluses and needed renminbi for certain local expenses (such as joint venture hotels that cater to foreign tourists and businessmen).

All currency swaps must be carried out under the supervision of the SAEC, which has established a number of currency swap centers in order to facilitate such transactions.[11] Some centers were established for the use of domestic Chinese enterprises only,[12] while others were intended to be used only by foreign investment enterprises.[13] The operations of the centers (and swap activity in general) are developing rapidly, and in many cities (including Beijing and Shenzhen)[14] foreign investment enterprises and domestic Chinese enterprises can now participate in the same market. Although procedures currently differ from center to center, the SAEC reportedly will soon relax restrictions on participation in currency swap activities throughout China, partly in order to ease pressures for another official devaluation of the renminbi.[15]

The swapping of renminbi for foreign exchange is conducted at a premium over the official exchange rate in order to provide an incentive to sell foreign exchange, and the premium varies with market forces from city to city. Some swaps were reported

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11. Currency swap centers have been established in cities where foreign investors tend to be most active, including Shanghai, Shenzehn, and Guangzhou. Following the decision to make Hainan Island a province with special economic status, a swap center was ambitiously set up in Haikou, its capital. According to a report in Hong Kong's Wen Wei Pao, May 14, 1988 (Bus. News Section), a total of 22 currency swap centers is planned. A later report predicted that provinces, municipalities, and autonomous regions "nationwide" will gradually be able to set up swap centers. *Foreign Currency Control Eased in Reform*, China Daily, July 11, 1988, (Bus. Weekly), at 1, col. 3. A recent review reports that 57 such centers will be operating by early 1989. Yowell, *Swap Center System to Expand*, China Bus. Rev., Sept.-Oct. 1988, at 10.

12. An example is the Shenzhen center. *See* Bus. China, Aug. 25, 1986, at 121. Its scope of business has since been extended so that it now covers the needs of state and collective enterprises, foreign investment enterprises, and even individual enterprises. *See* U.S. Foreign Commercial Serv., *An Investor's Guide to Foreign Exchange in China*, at ¶ 21 (Apr. 1988).

13. *See, e.g.*, Interim Provisions of Shanghai Municipality Concerning the Business of Mutual Adjustment of Foreign Exchange Among Foreign Ventures (issued Nov. 5, 1986) (unpublished).

14. U.S. Foreign Commercial Serv., *supra* note 12, at ¶¶ 8, 12.

15. *See* Yowell, *supra* note 11.

to have been made at rates as high as Y6.20 renminbi to one U.S. dollar in early 1988, as compared to the official rate of Y3.72 renminbi to the dollar. Although the SAEC has attempted to maintain a ceiling on exchange rates by refusing to approve swaps at exchange rates that depart too far from the official rate, it has otherwise refrained from interfering directly in the swap process, allowing the parties a fairly free hand to negotiate the price and other terms of each transaction. There are indications that the SAEC may attempt to maintain exchange rates in currency swap centers within a pre-determined range by participating in the market through buying and selling foreign exchange rather than relying only on its power to refuse approval where it considers the exchange rate too high.[16]

Despite the fact that foreign investment enterprises have had to pay premiums of thirty to sixty-six percent over the official exchange rate to obtain foreign exchange, currency swapping has become quite common. According to one study, $71 million in swaps were approved in Beijing and Shanghai between November 1986 and early 1988, and 130 of Shanghai's 220 foreign investment enterprises in operation have used the Shanghai currency swap center.[17] The Guangzhou currency swap center handled $120 million in swaps among foreign investment enterprises between June 1986 and May 1988.[18]

With such large sums of money changing hands, there is an obvious need for national regulations governing currency swaps. Currency swap procedures tend to vary from center to center, and there also appear to be quite large discrepancies in exchange rates. Such a situation suggests that there may be opportunities for currency arbitrage, which the SAEC would probably wish to avoid. The taxation implications for foreign exchange losses or gains resulting from currency swap activities also require clarification.

B. *Export of Products Sourced in China*

Because of the zeal with which it protects the monopoly conferred upon its own trading companies, China does not allow foreign companies to establish rival trading operations in China, although the representative offices established by many foreign

16. *Id.*
17. U.S. Foreign Commercial Service, *supra* note 12, at ¶ 14.
18. Wen Wei Pao, *supra* note 11.

trading companies in practice exceed the functions of mere liaison offices. For this reason, the PRC is very sensitive to suggestions that foreign investment enterprises be allowed to import goods other than components or materials required for manufacture of their products or to export goods other than their products. Yet, to a very restricted extent, foreign investment enterprises are now allowed to purchase products from Chinese enterprises for renminbi and to export them as another method by which such enterprises can earn foreign currency to balance their foreign exchange accounts.

This method was first sanctioned for joint ventures by the 1986 Foreign Exchange Balancing Provisions[19] and is dealt with in more detail by the Measures of the Ministry of Foreign Economic Relations and Trade for Enterprises with Foreign Investment to Solve the Balance of Foreign Exchange Receipts and Expenditures by Purchasing Domestic Products for Export (Measures for the Purchase and Export of Domestic Products).[20] The latter measures, promulgated a year after the former provisions, extended the scope of this method to all foreign investment enterprises but made it clear that such exports can only be resorted to on a short-term basis and only by foreign investment enterprises that are experiencing temporary difficulties in balancing their foreign exchange accounts.[21] The quantity of domestic products that can be exported under these measures is also limited to the amount necessary to obtain the foreign exchange required for the production of products in China and the distribution of profits to the foreign investor.[22] Official approval must be obtained on an annual basis.

In practice, the range of Chinese products available for export by foreign investment enterprises is often restricted to the least desirable ones—those that do not already have a ready ex-

19. *Supra* note 8. Article 6 states: "In order to seek to achieve a balance between foreign exchange receipts and expenditures, Chinese-foreign joint ventures may, with the approval of the foreign economic relations and trade departments, utilize the sales connections of foreign joint ventures to market domestic products for export, and carry out overall compensation." The article goes on to state that special approval must be obtained for products that require export licenses or are subject to export quotas.

20. Measures of the Ministry of Foreign Economic Relations and Trade for Enterprises with Foreign Investment to Solve the Balance of Foreign Exchange Receipts and Expenditures by Purchasing Domestic Products for Export (promulgated Jan. 20, 1987) [hereinafter Measures for the Purchase and Export of Domestic Products].

21. *Id.* art. 2.

22. *Id.* art. 4.

port market, at least at the price desired. Foreign investment enterprises have found it extremely difficult to persuade Chinese enterprises that possess products suitable for export to sell such items for renminbi when they could earn highly sought-after foreign exchange themselves by selling abroad directly or through state trading corporations. Moreover, official approval is especially difficult to obtain if the source of the product is located in another province or operates under the direction of a different ministry from the one that governs the foreign investment enterprise. Cooperation between ministries is still a relatively rare phenomenon in the PRC, although some progress is being made in promoting it.

A number of foreign investment enterprises, however, have reportedly been able to export substantial quantities of Chinese products for the purpose of balancing their foreign exchange accounts, especially those that can take advantage of the needs of the foreign investor's worldwide operations and demonstrate that they are thereby creating new markets for China rather than infringing on the "rice bowl" of the state trading companies.[23] Compensation trade, processing, and other flexible forms of doing business can sometimes become vehicles for expanding these opportunities, and foreign investment enterprises that can add value to a local product before exporting it may enhance their prospects for purchasing it. Both in dealing with the PRC bureaucracy and in finding export possibilities, ingenuity, flexibility, and pertinacity are the watchwords of those enterprises that have thus far succeeded in such transactions.

C. *Reinvestment in Foreign Exchange Earning Enterprises*

Another method by which a foreign investor can generate foreign exchange under the Foreign Exchange Balancing Provisions is to reinvest renminbi profits from its joint venture in a Chinese enterprise that earns foreign exchange. The additional foreign exchange that such investment enables the Chinese enterprise to earn can then be used to repatriate the foreign investor's profits from the original joint venture.[24]

On its face, this provision allows foreign companies to invest directly in Chinese enterprises—quite a revolutionary concept.

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23. *See* Frisbie, *Balancing Foreign Exchange*, China Bus. Rev., Mar.-Apr. 1988, at 24, 28.

24. Foreign Exchange Balancing Provisions, *supra* note 8, art. 10.

At present, however, only reinvestment in other foreign investment enterprises is practical. Nevertheless, investment in wholly domestic Chinese companies may become feasible if the current trends of transforming certain state and collective enterprises into share-issuing entities (or joint stock companies) continue.

Yet this method is not very attractive to foreign investors, who may, understandably, be quite reluctant to commit further investment funds in China when they are still unable to realize a return in foreign exchange on funds already invested. Nor is the method attractive to Chinese enterprises, because they will have to pay out foreign exchange to the foreign investor in return for a renminbi investment. Unless foreign investors are prepared to make such reinvestment arrangements more attractive to a Chinese enterprise—for example, by also investing foreign exchange in it, by providing it with advanced technology, or by offering the Chinese enterprise a new export channel—they are unlikely to arouse interest.

D. Loans

Foreign investment enterprises may also take out short-term or medium-term foreign exchange loans from banks within China or overseas for a variety of operating purposes.[25] However, this method can only overcome temporary foreign exchange shortages, for the loan and its interest will eventually have to be repaid with foreign exchange.

It should be noted that a foreign investment enterprise that earns foreign exchange income but still requires renminbi to pay local costs can preserve its foreign exchange by using it as collateral for renminbi loans rather than simply selling it to the Bank of China for renminbi. The foreign exchange collateral is returned when the renminbi loan is repaid. This method was first allowed by the 22 Articles,[26] and the People's Bank of China in December, 1986, issued detailed rules on the making of such loans.[27] To the extent that this latter method is implemented, it

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25. Regulations for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures, art. 78 (issued by the State Council on Sept. 20, 1983) [hereinafter Joint Venture Implementation Regulations]; Measures of the Bank of China on Lending to Enterprises with Foreign Investment (issued by the Bank of China on Apr. 14, 1987).

26. *Supra* note 4, art. 14.

27. Interim Procedures Concerning Renminbi Loans to Enterprises with Foreign Investment Secured by Foreign Exchange (issued Dec. 12, 1986).

will add a welcome degree of flexibility to the management of foreign exchange accounts for those enterprises reluctant to part with foreign exchange by swapping it for renminbi, even at a premium. However, at best it can be of assistance to only a limited number of foreign investment enterprises. Indeed, if many foreign investment enterprises resort to it, this may significantly restrict the amount of foreign exchange available in the swap markets.

E. Allocation of Foreign Exchange by Government Authorities

The rather broad and ambiguous provisions of Articles 61 and 75 of the 1983 Joint Venture Implementation Regulations contained the possibility that PRC government authorities would undertake responsibility to make up a joint venture's foreign exchange deficit by buying at least a limited amount of renminbi from it at the official exchange rate with foreign exchange from their own reserves.[28] These provisions raised false hopes that China was embarking upon a liberal policy to permit foreign investment enterprises to sell their products primarily in the PRC domestic market and then change the renminbi received into hard currency for the purpose of balancing the enterprises' foreign exchange accounts.[29]

An additional legislative basis for governmental "adjustment" of foreign exchange deficits can be found in the subsequent Foreign Exchange Balancing Provisions.[30] In the eyes of foreign investors, Article 3 of those provisions is very encouraging because it appears to direct government authorities at various levels to assume the responsibility for resolving joint ventures' foreign exchange problems. But, in the eyes of government officials, that article constitutes a warning, suggesting that, if joint ventures are unable to balance their foreign exchange accounts, the government authorities that approved the joint ven-

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28. Joint Venture Implementation Regulations, *supra* note 25.

29. Gelatt, *The Foreign Exchange Quandary*, CHINA BUS. REV., May-June 1986, at 28, 28. This provision is not a "self-implementing 'guarantee.'" *Id.* Any contemplated arrangement would have to be negotiated and approved. A few arrangements of this nature were approved in 1984, although the language of the assurances was not always very precise. The dwindling of China's foreign exchange reserves during 1985-1987 made even vague government undertakings based on this provision extremely difficult, if not impossible, to obtain.

30. *Supra* note 8, art. 3.

ture become responsible for resolving the problem by using their own foreign exchange reserves.

Consequently, Chinese contract negotiators and approval authorities have shown themselves singularly reluctant to include any references to the Foreign Exchange Balancing Provisions in joint venture contracts. Indeed, they usually attempt to include in such contracts provisions making the foreign party and the joint venture responsible for resolving any foreign exchange imbalance suffered by the venture. This is designed to enable the authorities to resort to article 7 of those provisions, which relieves them of any responsibility to resolve the problem if the foreign exchange shortage results from the venture's failure to complete the export and foreign exchange generation tasks it has undertaken in the contract.

In 1987, however, there were a number of widely publicized cases of government authorities (including those in Beijing, Shanghai and Guangzhou) directly or indirectly providing foreign exchange funds to joint ventures at the official exchange rate on an ad hoc basis. Those cases in part reflected the improving situation in China's foreign exchange reserves.[31] They also reflected the PRC's recognition that many well-known joint ventures were facing difficulties with foreign exchange, that China's reputation as a favorable foreign investment environment needed bolstering, and that the most effective measure China could take to improve its reputation was to solve the foreign exchange problems of such ventures.

Fortunately, the Measures for the Purchase and Export of Domestic Products,[32] in addition to assisting foreign investment enterprises directly, provide local governments with a means of generating foreign exchange income that the governments can use to assist foreign investment enterprises to balance their foreign exchange accounts. Article 8 of those measures allows provincial governments and certain municipal governments to organize the exportation of local products and to use the additional foreign exchange income generated thereby to "adjust and resolve" foreign exchange deficits in foreign investment enterprises under their jurisdiction. According to a senior Guangzhou official, Guangzhou municipality used this provision

31. *See, e.g., Forex Reserves Top U.S. $15 b.*, Ta Kung Pao, Apr. 7-13, 1988, at 4 (Weekly Supp.).

32. *Supra* note 20.

to provide four million dollars at negotiated prices to foreign investment enterprises under its jurisdiction during 1987.[33]

F. *Flexible Pricing*

Wholly apart from formal import substitution procedures, on an ad hoc basis a number of joint ventures have been given permission to sell products within China for either foreign exchange or renminbi. This has enabled these joint ventures to adopt a flexible pricing policy that, in effect, operates as a foreign exchange balancing mechanism. Thanks to recent foreign trade reforms, which allow domestic enterprises to retain a larger portion of foreign exchange income than in the past, and thanks to China's improving foreign exchange situation, this method has become increasingly important.

Some joint ventures give preference to Chinese customers that can make their purchases in foreign exchange. Others offer a choice of paying in either foreign exchange or in renminbi, but the renminbi price is set at a level to reflect the cost of obtaining the foreign exchange required in the course of operating the venture. Therefore, if the joint venture must buy foreign exchange through currency swaps at rates higher than the official one, it will incorporate the higher costs in its renminbi price. Moreover, if a joint venture is short of foreign exchange, it can sell for either renminbi or foreign exchange, but it may raise its renminbi price to discourage renminbi sales and to encourage foreign exchange sales. It may correspondingly lower the renminbi price when renminbi revenue is required.[34]

Local governments take differing views of such practices. They are more widely tolerated in Shanghai and the south of China than in Beijing, where the municipal government exercises strict control over pricing practices.[35]

G. *Evidence Accounts*

Another method proposed by foreign investors to assist them in the repatriation of foreign exchange from foreign investment en-

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33. Statement by Mr. Liu Bin, Deputy Chairman, Guangzhou Commission for Foreign Economic Relations and Trade, at an investment promotion seminar in Hong Kong (Jan. 29, 1988).

34. According to a foreign investor involved in a joint venture established in Shenzhen, such a flexible pricing policy has been the key to the joint venture's success.

35. U.S. Foreign Commercial Service, *supra* note 12, at ¶¶ 32 & 33.

terprises in China is the establishment of an "evidence account" system. An evidence account would record a foreign investor's hard currency purchases from all of China, from a certain locality, or from a cluster of enterprises under a Ministry and would give the foreign investor "credit" for such purchases when determining the degree of governmental assistance to be provided in resolving the investor's hard currency problems. The foreign investor would then be able to convert its renminbi profits into foreign exchange at the official rate in accordance with a formula that to some extent reflects the amount of foreign exchange the foreign investor had provided to China through its purchases.

Development of such a system would be extremely attractive to potential foreign investors. It would permit them to take advantage of existing purchases from Chinese enterprises that are unrelated to their foreign investment enterprise. It would also encourage foreign investors to source within China purchases currently made elsewhere and thereby add to their foreign exchange credit. Thus, this method could not only lead to a substantial increase in foreign investment in China but could also bring about an expansion of PRC exports.

Despite the obvious benefits that evidence accounts could bring to China, the government has not yet indicated whether it will approve establishment of such a system. On an ad hoc basis, however, Shanghai, in deciding upon how much hard currency aid to give a joint venture, has reportedly taken account of new and significant purchases within the municipality by the foreign investor in that venture.

III. Import Substitution

We have seen that some foreign investment enterprises have been permitted to sell products for foreign exchange within China on an ad hoc basis as one way of assisting them to balance their foreign exchange accounts. If foreign investment enterprises can contribute to the development of China's industrial sector by producing substitutes for products that China is otherwise required to import, the enterprises raise a strong argument that for their domestic sales, which constitute "import substitution," they should be entitled to receive at least some foreign exchange that would otherwise be spent on importing equivalent products. This option will be analyzed in detail in the following sections.

A. *Initial Authorizing Legislation*

When the Chinese authorities came to recognize that tight foreign exchange controls presented great difficulties to foreign investment enterprises and thus discouraged foreign investment, they relaxed the controls somewhat in 1983. The SAEC issued the Rules for the Implementation of Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprises and Chinese-Foreign Equity Joint Ventures (Exchange Control Implementation Rules),[36] which permit foreign investment enterprises to sell some products to Chinese entities for foreign exchange, provided that the products meet certain criteria and the enterprises first go through a special approval procedure.

The Exchange Control Implementation Rules state the general principle that foreign investment enterprises must settle all their accounts with Chinese government agencies and enterprises (including other foreign investment enterprises) in renminbi[37] but then specify four exceptions when foreign currency may be used. The exception relating to import substitution states:

> When products manufactured by these enterprises are commodities that China needs to import and they are sold to Chinese units engaged in foreign trade or to other enterprises, these enterprises may, with the approval of the Chinese foreign trade agency in charge and the agreement of both the supplier and buyer, compute the price and settle accounts in a foreign currency, with reference to the international market price.[38]

The Exchange Control Implementation Rules also state that if the investment and profits are to be recovered by the foreign investor in the form of products (and particular reference is made to investment in the exploitation of offshore petroleum resources, coal, and other natural resources) and if sales are made within China, then they should be handled in accordance with the import substitution provision quoted above.[39]

The Joint Venture Implementation Regulations,[40] issued later in 1983, confirm the availability of such import substitu-

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36. Rules for the Implementation of Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprise and Chinese-Foreign Equity Joint Ventures (promulgated Aug. 1, 1983).

37. *Id.* art. 12.

38. *Id.* art. 12(1).

39. *Id.* art. 14.

40. *Supra* note 25.

tion but apparently on a much more restricted basis. Article 64(d) states: "If the joint venture's export products are items that a Chinese foreign trade corporation wishes to import, the joint venture may sell such products to the foreign trade corporation and receive its payment in foreign exchange." The regulations, however, opened up the possibility for equity joint ventures to sell their products primarily on the domestic market for renminbi and authorized Chinese government authorities to provide undertakings to such ventures to make up any foreign exchange deficits that might be incurred.[41] In view of this fact, the more restrictive formulation regulating import substitution per se that accompanied this apparent breakthrough seemed to be of little consequence, especially in view of the broader authorization contained in the Exchange Control Implementation Rules.

B. *The Foreign Exchange Balancing Provisions*

As we have seen, the 1986 Foreign Exchange Balancing Provisions,[42] while reiterating the importance of exports, restated and added to the methods available to a joint venture to balance its foreign exchange receipts and expenditures. The fact that the Chinese authorities had reacted to the very real and pressing foreign exchange problem by formulating these provisions was universally welcomed, but the terms of the Foreign Exchange Balancing Provisions—to the extent their vagueness permitted accurate understanding—did not promise an early resolution of the problem. Indeed, it was not clear whether the provisions relating to import substitution and related methods of earning foreign exchange from domestic sales of joint ventures actually represented progress over the Exchange Control Implementation Rules and the Joint Venture Implementation Regulations of 1983.

The Foreign Exchange Balancing Provisions (as poorly drafted a piece of PRC legislation as the authors have encountered) appeared to offer three separate possibilities for joint ventures to earn foreign exchange from their domestic sales. Article 8 authorized any joint ventures, after obtaining the approval of the State foreign exchange control department, to be paid in foreign currency for sales made to "enterprises with the ability to make payment in foreign exchange in areas other than the spe-

41. *See supra* text accompanying notes 28-29.
42. *Supra* note 8.

cial economic zones and the economic and technological development zones of the coastal open cities." Presumably this provision, which confirmed existing practice and reformulated earlier legislation, was not made applicable to the special economic areas because it was already clear that in those areas no special approval was necessary for foreign exchange payments to be made.[43]

In most cases, of course, PRC enterprises lack sufficient foreign exchange of their own to make significant purchases. Consequently, joint ventures selling into the domestic market would have to depend on the appropriate level of government either to provide foreign exchange directly to the joint ventures or to provide it, under import substitution procedures, to enterprises that purchase from the ventures.

Article 4 of the Foreign Exchange Balancing Provisions provided for the former possibility. Yet, unlike the Joint Venture Implementation Regulations, which seemed to permit a broad variety of ventures to sell primarily on the domestic market and to authorize government assistance to them in balancing their foreign exchange account, article 4 indicated that government assistance might only be forthcoming

> in cases where the foreign joint venturer provides highly sophisticated products produced with advanced technology or key technology, or products of superior quality that are internationally competitive, if such products are urgently needed in China, after the products have been appraised and found by the departments in charge to be up to standard.

Moreover, ventures that managed to meet that test would not be assured that they could sell their products primarily on the domestic market but were only promised unspecified "preferential treatment with respect to the proportion of domestic sales and the period of domestic sales."

Article 5 of the Foreign Exchange Balancing Provisions provided that joint ventures "that produce products that China needs to import over the long term or urgently needs to import may, in accordance with the quality, specification requirements and import circumstances of the products in question, [and with government approval,] carry out import substitution." This was

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43. Joint Venture Implementation Regulations, *supra* note 25, arts. 61 & 75. *See* Ta-kuang Chang, *Foreign Exchange Balancing Provisions for Joint Ventures*, E. Asian Exec. Rep., Feb. 1986, at 7, 9.

essentially a restatement of the relevant provision in the Exchange Control Implementation Rules. Article 5 did state that import substitution "shall be specified" in the joint venture contract or the contract between the venture and the end-user and that government foreign trade departments "shall actively support Chinese end-user units" in concluding their purchase contracts. Apart from that, however, article 5 cast no new light on how import substitution was to proceed, other than to indicate that the foreign exchange required for the purchase was to be authorized by the approved foreign exchange use plans of the end-users.

When they were issued, the Foreign Exchange Balancing Provisions were accompanied by a statement from a leading Chinese official indicating that they would be quite restricted in their application. Gu Ming, head of the Economic Legislation Research Center under China's State Council, was reported to have said that it was not possible "for a developing country like China to use its scarce foreign exchange reserves to subsidize joint ventures running a deficit in foreign exchange earnings."[44]

During the year following the issuance of the Foreign Exchange Balancing Provisions, many potential foreign investors were told by Chinese officials not to pay too much attention to the provisions' terms as they could not be implemented in practice. PRC foreign trade negotiators strongly resisted any reference to those provisions in contracts establishing foreign investment enterprises despite the fact that the provisions specifically authorized such contracts to specify details if import substitution was to be carried out.[45] This was a rather disquieting experience. It appears that the provisions were premature, having been issued at a time when China was still suffering a serious foreign exchange shortage.[46]

Furthermore, it became increasingly apparent that, if import substitution was ever to become a serious option for foreign investment enterprises, the mystery surrounding it would have to dissipate and details concerning the criteria, institutions and procedures for putting it into effect would have to be made known.

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44. Foreign Exchange Balancing Provisions, *supra* note 8, art. 4 (*quoted in* Liu Dizhong, *New Rules Beat the Currency Problem*, China Daily, Jan. 21, 1986, at 1, col. 1).

45. Forein Exchange Balancing Provisions, *supra* note 8, art. 5.

46. For details of the serious foreign exchange drain at that time, see Stuermer, *The Foreign Exchange Situation*, CHINA BUS. REV., Jan.-Feb. 1986, at 14.

C. *Guangdong Import Substitution Procedures*

Although the 22 Articles of October 1986 do not themselves address the possibility of import substitution, some subsequent local regulations do allow for import substitution.[47] The best-known and most comprehensive of these local provisions appeared in December 1986, when Guangdong Province anticipated national legislative action by adopting its own regulations on import substitution—the Trial Procedures Concerning the Use of Products for Import Substitution (Guangdong Procedures).[48]

The Guangdong Procedures apply to technologically advanced foreign investment enterprises that manufacture products that Guangdong Province lacks or for which it has long-term or urgent import requirements.[49] Products may be listed as import substitution products if they are produced either by joint ventures or by state or collective enterprises that have borrowed foreign exchange to import advanced technology and equipment.[50] The performance and quality of import substitution products must "basically" meet international standards, and their prices must be set "with reference to" prevailing international prices.[51] Substitution products are also subject to supervision and periodic qualification inspections by commodity inspection bureaus, and failure to maintain standards can lead to cancellation of their status as import substitutes. For inclusion of a product in the provincial import substitution product list, approval must be obtained from the local department in charge of the industry concerned and the provincial economic, planning and foreign trade commissions.[52]

Guangdong has adopted several lists of import substitution products that total over fifty products. Of the thirty-eight products published in the first two lists, twenty-six are produced by foreign investment enterprises.[53] Of those thirty-eight products,

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47. *See, e.g.*, Mitchell, *Local Foreign Investment Regulations: Shopping for the Right Location in China*, E. ASIAN EXEC. REP., Feb. 1987, at 9, 15-19.

48. Trial Procedures Concerning the Use of Products for Import Substitution (promulgated by the Guangdong Provincial People's Government, Dec. 8, 1986) [hereinafter Guangdong Procedures].

49. *Id.* art. 1.

50. *Id.* art. 2. The Guangdong Procedures do not specifically provide for (or prohibit) import substitution by wholly foreign owned enterprises.

51. *Id.* arts. 2 & 4.

52. *Id.* art. 3.

53. *Guangdong Approves 38 Import Substitutes*, China Econ. News, Oct. 5, 1987, at 4.

twenty-four are produced in the Shenzhen Special Economic Zone, eighteen of them by foreign investment enterprises there.[54] The import substitution products include color television sets, computers, color photograph developing chemicals, ring-pull cans, transport containers, and electronic components.[55]

D. National Import Substitution Measures

The Guangdong Procedures provide that, if ventures in Guangdong wish to have their products receive import substitution treatment on a nationwide scale, the provincial economic commission would have to obtain the approval of the State Economic Commission in Beijing. This suggested the availability of national import susbstitution treatment even in the absence of national legislation. Yet, national legislation was obviously desirable.

That legislation finally appeared when in October, 1987, the State Planning Commission issued the Measures Concerning Import Substitution for the Products of Chinese-Foreign Equity and Cooperative Joint Ventures (Import Substitution Measures).[56] The Import Substitution Measures are more restrictive than the Guangdong Procedures in prescribing the conditions that must be satisfied before a joint venture can qualify to practice import substitution for the products it manufactures.

The Import Substitution Measures are careful to limit their application to productive joint ventures that manufacture products "truly needed in China" and that can provide advanced technology and upgrade products or develop new products.[57] They do not apply to domestic Chinese enterprises (unlike the Guangdong Procedures), to wholly foreign-owned enterprises, or to joint ventures of a non-productive nature, such as hotels, taxi companies, consultancy businesses, and other service industries. Under these measures, there must be a future as well as a current demand for the products proposed as import substitution

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54. Shenzhen Special Zone Daily (Shenzhen Tequ Bao), July 27, 1987.

55. *Guangdong Approves 38 Import Substitutes*, *supra* note 53.

56. Measures Concerning Import Substitution for the Products of Chinese-Foreign Equity and Cooperative Joint Ventures (issued Oct. 19, 1987) [hereinafter Import Substitution Measures].

57. *Id.* art. 2.

products,[58] and they must undergo strict examination and meet conditions relating to quality, specifications, performance, delivery times, technical services, and training.[59] Moreover, the prices of such products must be internationally competitive "in principle."[60]

In addition, the Import Substitution Measures are clearly designed to assist qualifying joint ventures only during the initial stages of production if they are in the process of achieving localization of production and encounter temporary foreign exchange balancing difficulties.[61] On applying for import substitution approval, the joint venture partners must provide a schedule for achieving substantial localization of production to show that the venture will be able to minimize future foreign exchange requirements for sourcing raw materials and parts overseas.[62]

The Import Substitution Measures also provide details of the approval procedure, which must begin at the earliest stage of a foreign investment project, when the potential Chinese investor submits its proposal for the joint venture project to the appropriate planning commission. The Chinese and foreign investors must jointly submit a feasibility study of the project for approval prior to completing negotiations on the joint venture contract. This study must contain details concerning the proposed import substitution, including not only localization of production schedules but also projected annual ratios between exports and domestic sales and projected annual quantities of import substitutes and foreign exchange earnings.[63] The application for import substitution must be submitted to the planning commission at the appropriate level, the level being determined primarily by the amount of investment involved and the nature of the product.[64]

An initial list of products for which national import substitution may be carried out was published together with the Import Substitution Measures. Judging from the nature of some of those products (which included pig iron, timber, copper, rubber,

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58. *Id.* art. 3(2).
59. *Id.* art. 3(3).
60. *Id.*
61. *Id.* art. 3(1).
62. *Id.* art. 4.
63. *Id.*
64. A good explanation of these procedures is found in Horsley, *China Announces National Import Substitution Rules*, E. ASIAN EXEC. REP., Dec. 1987, at 8.

wood pulp, and man-made silk), the degree of sophistication required by the "advanced technology" precondition in article 2 may not be very high.

At the same time as the Import Substitution Measures were promulgated by the State Planning Commission, the State Economic Commission promulgated complementary measures relating to the administration of import substitution for mechanical and electrical products (Mechanical and Electrical Products Measures),[65] which were formulated pursuant to article 10 of the Import Substitution Measures. The main difference between the two sets of measures is that all approvals for import substitution for mechanical and electrical products must be made at the national level (regardless of the amount of investment involved) by the State Economic Commission (rather than the State Planning Commission). This distinction between the two commissions, however, is no longer relevant following their merger, which was announced during the 7th National People's Congress in April, 1988.

The Mechanical and Electrical Measures contain similar conditions relating to qualification for import substitution approval but also require that joint ventures applying for import substitution must have fulfilled their export responsibilities in accordance with their approved contracts. This requirement, if taken literally, would preclude import substitution treatment for a venture at the outset of its operation.

When the Mechanical and Electrical Measures were promulgated, the first list of products for import substitution was appended. That list only contained two products, both of which are produced by joint ventures (China Schindler Elevator Company, Ltd., and the Shanghai Foxboro Company, Ltd.). By early 1988, four additional lists had been published, containing over 340 different kinds of mechanical and electrical products.[66]

E. Implementation of Import Substitution

What assistance does the new national legislation give to joint ventures that manage to qualify under its provisions? Is the

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65. Measures for the Administration of Import Substitution for the Mechanical and Electrical Products of Chinese-Foreign Equity and Cooperative Joint Ventures (issued in Oct. 1987).

66. Wen Wei Pao (Hong Kong), Dec. 19, 1987, at 2; Wen Wei Pao (Hong Kong), Jan. 11, 1988, at 25.

game worth the candle? In this respect it is interesting to note some subtle but important differences between the Import Substitution Measures and the Guangdong Procedures.

The Guangdong Procedures provide that provincial purchasers must give priority to products designated as import substitutes and "in principle" shall no longer import such products. No such imports are to be permitted without special approval by the province's leading group responsible for foreign economic relations, and, if an attempt is made to import without approval, "banks shall not release funds for payment and Customs shall not release the goods."[67]

The Import Substitution Measures also require end-users to give priority to import substitutes but add the proviso "under equal conditions;" moreover, they merely state that import control and examination departments shall "guide and encourage" end-users to give priority to those products.[68] No mention is made of any "in principle" ban on imports or of sanctions to be imposed against unapproved imports, as in the Guangdong Procedures. This toning down of the legislative language relating to implementation probably reflects a PRC effort to insulate the national legislation against criticism that might be made of the Guangdong Procedures on the ground that its import barriers may violate the provisions of the General Agreement on Tariffs and Trade (GATT), in which China is now seeking representation.[69] It may also reflect the criticisms of import substitution by those economists, inside and outside the PRC, who believe that this practice is economically inefficient and adverse to a country's long-term development.

The entire range of techniques that PRC agencies are prepared to use to "guide and encourage" the purchase of import substitutes is unclear. Chinese officials deny that these techniques would include outright prohibition of imports, yet their powers of persuasion are often very great. Tariff and import license techniques enable the PRC to maintain imports in principle but curtail them in practice, as has recently been the case with various products, such as automobiles and elevators, that are produced by large-scale joint ventures in China and sold there as import substitutes. In some cases, imports that are to be

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67. Guangdong Procedures, *supra* note 48, art. 5.

68. Import Substitution Measures, *supra* note 56, art. 8.

69. China submitted its formal application to GATT in July 1986. *See* China Daily, Feb. 16, 1987, at 1, col. 1.

sold in excess of a certain price are restricted. In other cases, a local government has acted to ensure that a local joint venture's import substitutes are purchased in lieu of the lower-priced imports, even though the prices of the competing imports had been slashed well below that of the import substitutes in a foreign effort to gain market dominance.

The new import substitution legislation, by confirming that part of the purchase price may be paid in renminbi and part in foreign exchange, has given foreign investment enterprises a better opportunity to compete against imports that are significantly less expensive. The Guangdong Procedures explicitly link one ratio—that of the amount of foreign exchange that can be received by a foreign investment enterprise as part of its sales price—to another ratio—that formed by the cost of the foreign materials and components used to produce the product, including amounts for depreciation on imported equipment, repayment of the invested capital, and distribution of profits, over the total cost of the product.[70] The Import Substitution Measures simply leave the renminbi-foreign exchange proportions to the agreement of the parties subject to the approval of the exchange control departments.[71] Under either of these regulations, a foreign investment enterprise whose import substitute is more expensive than that of a competing import can make the renminbi portion of the sales price sufficiently great so that the foreign exchange portion is substantially less than the price of the import. Thus, although the total cost of the import substitute to the purchaser would be greater than that of the import, the foreign exchange cost would be lower, thereby often making the import substitute more attractive.

The approval document granting import substitution status usually states both the specific duration of such status—ordinarily no more than five to seven years—and the formula to be used for determining the renminbi-foreign exchange proportions of the product's price. Although, unlike the Guangdong Procedures, the national legislation does not offer detailed criteria for deciding on this formula, in practice it, too, is usually calculated by reference to the enterprise's foreign exchange expenses. Thus, the foreign exchange proportion is expected to diminish in accordance with progress made in imple-

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70. Guangdong Procedures, *supra* note 48, art. 7.
71. Import Substitution Measures, *supra* note 56, art. 9.

menting the schedule for localization of production. It should be noted that total localization is rarely expected since the authorities are often willing to settle for a percentage that is reasonable in light of the circumstances.[72]

It is too early to assess the success of the new national legislation in easing the foreign exchange problems of foreign investment enterprises. Even after such an enterprise is approved to practice import substitution, it is still faced with many difficulties. For example, it has to overcome the common prejudice of PRC officials and managers against locally made products, which are often considered to be inferior in quality to imported ones, even if made in cooperation with foreign companies. Moreover, overseas procurement generally involves benefits to procurement officials, such as trips abroad, which are normally not available if import substitutes are purchased, and officials are reluctant to lose these benefits.[73] Yet, if vigorously implemented by both foreign investment enterprises and relevant PRC agencies, this method of balancing foreign exchange may prove to be the most promising of all.

72. Interviews with Beijing municipal officials.

73. In an effort to cope with this situation, one Shanghai joint venture is reportedly willing to help arrange visits to its U.S. manufacturing facilities by its Chinese customers as an incentive to the purchase of import substitution products manufactured in China. Foreign investors subject to the U.S. Foreign Corrupt Practices Act should only undertake such efforts after confirming that they would not violate that Act.